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Q1 2007

VENTURE CAPITAL MONITOR

A QUARTERLY UPDATE ON THE CANADIAN VENTURE CAPITAL INDUSTRY

The Canadian venture capital (VC) industry is a key contributor to the growth of innovative firms that commercialize research. For this reason, the health of this industry is an ongoing concern. The goal of this series is to provide current information about this key enabling industry. To this end, the series will track trends in investment activity, report on topical VC-related research and look at key technology clusters where VC investment is taking place.

Introduction
VC Activity Overview
"In Focus" – Vancouver
Notes

Introduction

This issue examines venture capital (VC) activity in Canada during the first quarter of 2007 and identifies some overall trends. It also lists recently announced federal and regional government VC policies and programs. The "In Focus" article highlights some key characteristics of the Vancouver VC market, its impact on local technology sectors and some actions that the Government of British Columbia is taking to further stimulate VC in British Columbia.

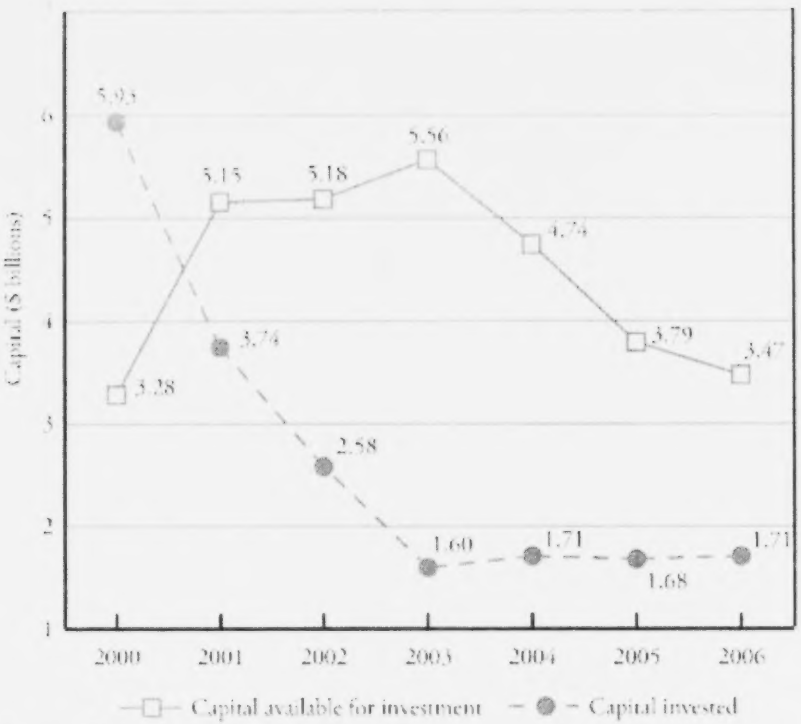
VC Activity Overview

Investment and fundraising trends

The Canadian VC market has witnessed a strong first quarter in 2007 with $598M invested, up 16 percent from the last quarter and up 62 percent from Q1 of 2006 (Table 1). Fundraising followed the same upward trend, increasing from $390M in Q4 of 2006 to $467M in Q1 of 2007. However, a quarterto-quarter comparison indicates that fundraising declined slightly from the $474M raised in Q1 of 2006.

Notably, there was $3.47B of capital available for investment at the end of 2006, compared with $3.79B at the end of 2005 and $5.18B at the end of 2002 (Figure 1). This raises an interesting question, Is the sustained decline in fundraising in the Canadian VC market a continued correction, in the aftermath of the technology bubble, to deplete the VC capital available for investment?

Figure 1: Capital available for investment and capital invested



Source: Thomson Financial Canada 2007.

Table 1
VC investments and fundraising, Q1 2006 and Q1 2007

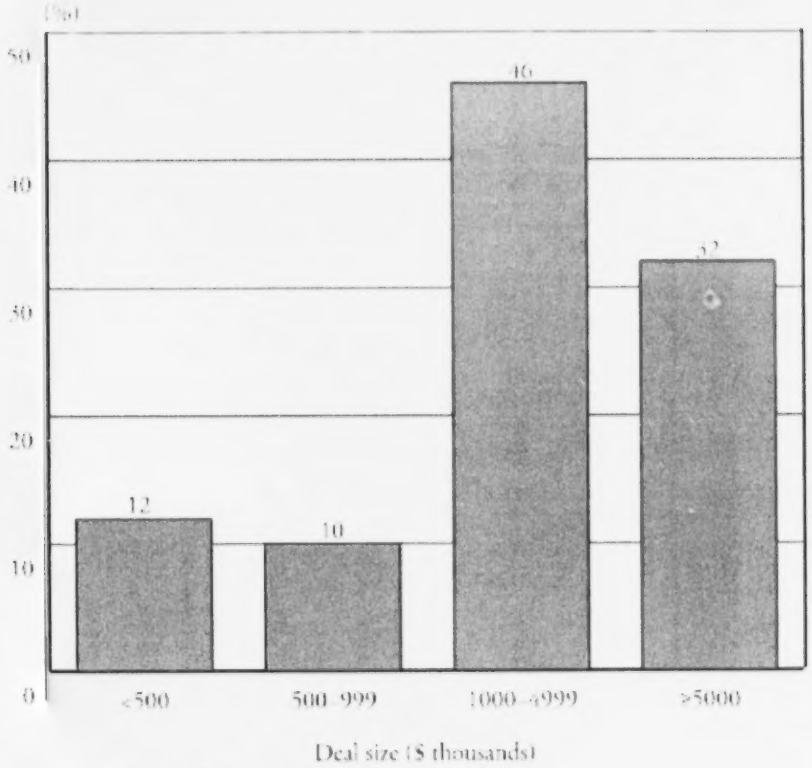
	Q1 2006	Q1 2007	
	($ millions)		% Change
Investments	370	598	61.62
Fundraising	474	467	-1.48

Source: Thomson Financial Canada 2007.

Deal size trends

In Q1 of 2007, the average deal size in Canada reached $4.6M. However, if an extraordinary $160M deal is removed from the calculation, the average deal size falls to $3.6M. Furthermore, analysis of Q1 2007 Canadian data reveals that 68 percent of Canadian deals were worth less than $5M (Figure 2). Foreign funds continue to push the average deal size upwards, with 85 percent of foreign deals worth more than $5M. Domestic investors concentrated most of their investments in deals worth less than $5M.

Figure 2: Distribution of deals by deal size, Q1 2007



Source: Thomson Financial Canada 2007.

Notably, seven deals made in Q1 of 2007 were worth more than $20M compared with only 12 such deals in all of 2006 and 16 in 2005. Fewer companies received financing in Q1 of 2007 than in Q4 of 2006.

investment stage trends

VC

During Q1 of 2007, the shift towards follow-on investment continued after a short-lived increase in new investments in Q4 of 2006. Followon investment represented 82 percent of total investments in Q1 of 2006 compared with 88 percent in Q1 of 2007, which means that new investments declined from 18 percent in Q1 of 2006 to 12 percent in Q1 of 2007 (Table 2). In absolute terms, however, the level of funding directed at new investments was approximately the same in both Q1 of 2007 and Q1 of 2006 at about $70M.

Companies that received VC for the first time accounted for a third of companies receiving VC in Q1 of 2007, roughly the same share they had in Q1 of 2006.

Table 2
New versus follow-on VC investment, Q1 2006-Q1 2007

	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007
			Amount invested ($ millions)		
New	71	81	50	143	69
Follow-on	299	403	292	374	529
			Number of Companies		
New	48	41	41	58	41
Follow-on	89	86	86	108	85

Source: Thomson Financial Canada 2007.

According to some observers, as most Canadian funds are nearing the end of their 10-year lifespan, there appears to be a sustained effort by VC fund managers to support existing portfolio companies with followon investments to prepare them for exit.

Regional distribution of VC investments

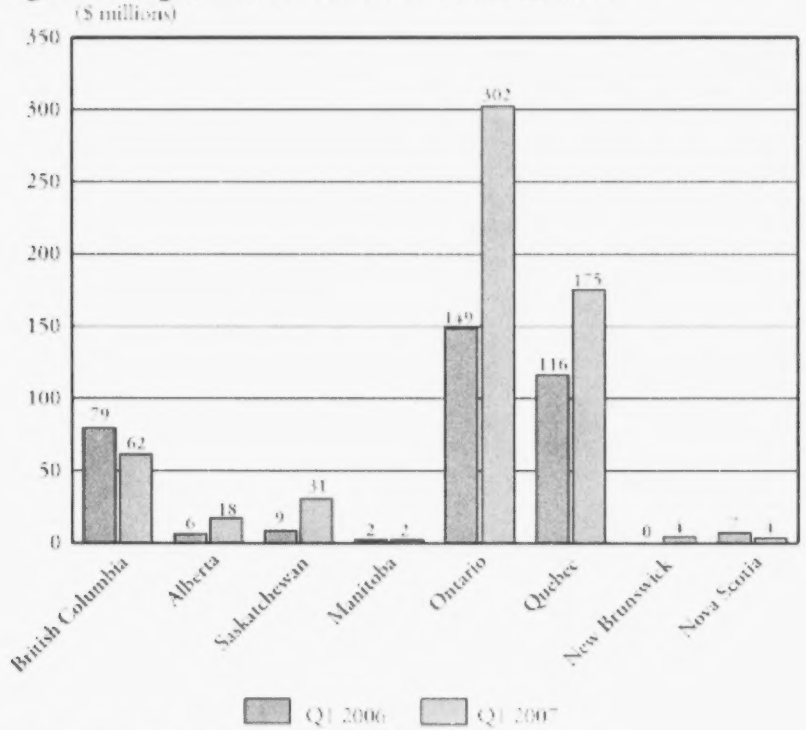
Ontario witnessed strong growth in VC investment in Q1 of 2007, reaching $302M, double the amount invested in Q1 of 2006 (Figure 3). However, this growth can largely be attributed to a single, extraordinary $160M deal for an online publications and content provider.

Quebec also showed strong growth as its Q1 2007 VC investment level reached $175M compared with $116M in Q1 of 2006.

VC investment in British Columbia fell from $79M in Q1 of 2006 to $62M in Q1 of 2007.

The number of companies in Canada receiving VC dropped by 9 percent in Q1 of 2007 compared with Q1 of 2006, with British Columbia experiencing a decrease of 28 percent (Table 3).

Figure 3: Regional distribution of VC investment



Source: Thomson Financial Canada 2007.

Table 3
Number of companies receiving VC by province

	Q1 2006	Q1 2007	% Change
British Columbia	18	13	-28
Alberta	4	4	0

Saskatchewan	4	2	-50
Manitoba	6	5	-17
Ontario	45	42	-7
Quebec	57	55	-4
New Brunswick	1	2	100
Nova Scotia	2	2	0
Total	137	125	-9

Source: Thomson Financial Canada 2007.

Investor trends in the VC market

Foreign funds, especially U.S. funds, with $304M invested in Q1 of 2007, represented 50 percent of total VC investment that quarter compared with 35 percent in Q1 of 2006. Although this increase can be attributed to a single, extraordinary $160M deal, foreign funds are increasingly a driving force in the Canadian VC market.

Private independent (PI) funds invested $93M during Q1 of 2007, up 34 percent from Q1 of 2006. PI funds' investment growth outpaced their fundraising activity, which remained flat at about $70M. Notably, the available PI fund investment capital at the end of 2006 was approximately $1.6B, up $100M from the $1.5B available at the end of 2005.

Retail funds invested $79M in Q1 of 2007, up 27 percent from Q1 of 2006. They raised $396M, of which 69 percent was raised in Quebec. Retail fundraising remained mostly flat compared with Q1 of 2006. Retail funds had $1.16B of capital available for investment at the end of 2006, down about $40M from the $1.20B available at the end of 2005.

Key sectors attracting VC investments

Information technologies (IT) dominated the attention of investors during Q1 of 2007. Even if the extraordinary $160M deal, which was IT related, is excluded from the data, the IT sector still attracts a sizable share of VC investment (Table 4).

The life sciences sector received $205M, an increase of 44 percent compared with $142M received in Q1 of 2006.

Table 4
VC investment distribution by sector

	Q1 2006	Q1 2007	
	($ million)		% Change
Life sciences	142	205	44
Information technologies	169	306	81
Other technologies	32	38	19
Traditional	25	47	85

Source: Thomson Financial Canada 2007.

VC-related government activities

In Q1 of 2007, the Business Development Bank of Canada (BDC) invested $27M, in addition to $149M invested by co-investors, in 17 companies (Table 5). It also invested $25M as a limited partner in the new Novacap Technologies Buyout III fund, which expects to raise $250M. BDC deals were distributed evenly between early and later stage investments.

Table 5
BDC deal distribution by stage of development, Q1 2007

	Number of Companies	Financing ($ million) BDC's Share	Other Co-Investors
Seed	2	2	4
Start-up	6	11	62
Expansion	5	5	14
Development	4	9	69
Total	17	27	149

Source: Business Development Bank of Canada, Q1 of 2007.

nent, with co-investors.

During Q1 of 2007, Farm Credit Canada (FCC) made a single investm

Provincial funds participated in seven deals totalling $53M.

ance Capital Fund (BCRCF)

The Government of British Columbia launched the new B.C. Renaissaribution to this fund is limited based on a public-private partnership model. The government's contnd. The fund will employ to $90M and cannot exceed 20 percent of the total amount of the fur to raise institutional funds. In general partners selected on the basis of their experience and ability of the fund from institutional fact, general partners are required to raise the remaining 80 percent new media[1] and clean sources. The BCRCF will target investments in the biotechnology, IT, technology sectors.

gy (S&T) Strategy entitled:

The federal government recently published its Science and Technolo federal government *Mobilizing Science and Technology to Canada's Advantage*.[2] In it, that that is conducive to greater committed to explore policy options to create a business environmen different approaches to private-sector innovation. This commitment will also consider new orstitutional investments in stimulate the supply of VC in Canada, including working to attract ins Canadian funds.

VC-relevant announcements in federal Budget 2007

further lower tax barriers to

Budget 2007 announced two measures, described below, designed tital flows into the Canadian foreign investment in Canadian companies and stimulate foreign capi market.

panies (LLCs)

Canadian tax treatment for U.S. limited liability com

treaty to include LLCs. U.S.

Canada and the United States agreed, in principle, to extend the tax establish themselves as institutional investors,[3] who under U.S. law are tax sheltered, tend tohe Canada-United States limited partners in LLCs set up as flow-through entities.[4] Currently, tl institutional investor that treaty does not extend any tax benefits to LLCs. As a result, any U.Sntity must pay Canadian earns a Canadian capital gain as a limited partner in a flow-through e capital gains tax.

nada-United States tax treaty,

VC fund managers have reported that this LLC exclusion from the Canal investors[5] away from and the resulting taxation implication, has driven many U.S. institutician technology companies Canadian investment opportunities. This effectively eliminates Canadthat extends the tax treaty to from an important source of financing. The measure in Budget 2007 increase the supply of U.S. include LLCs seeks to rectify this situation and should eventually help VC investment in Canada.

Extending the definition of prescribed stock markets

Budget 2007 announced a change to tax legislation that will allow all stock markets in Organisation for Economic Co-operation and Development (OECD) countries to be recognized as prescribed stock markets.[6]

To expand their sources for fundraising, some Canadian technology companies list their shares on foreign stock exchange markets in view of a number of perceived advantages. For instance, many Canadian technology companies choose to raise funds on the London Alternative Investment Market, a stock exchange targeting growth companies and offering flexible regulatory requirements. Prior to this year's budget announcement, sale of Canadian shares on this market was subject to withholding requirements under section 116 of the *Income Tax Act*, which meant that a purchaser of Canadian shares was required to hold 25 percent of sale proceeds for the Canada Revenue Agency (CRA), unless the seller had obtained a clearance certificate from the CRA. This requirement placed Canadian firms listed on these markets at a disadvantage vis-à-vis foreign firms listed on the same exchange.

▲ Top

"In Focus" – Vancouver

Vancouver, Canada's west coast technology hub, attracted 93 percent of British Columbia's total VC investments between 1996 and 2005. Its key sectors were life sciences and information technologies, which together received 77 percent of total VC investment in 2006. This percentage was even higher a few years ago. However, the emerging clean technology sector has started capturing a growing share of VC investments, attracting $47M in 2006.

Investors' focus on Vancouver is largely due to its world-class research centres, such as The University of British Columbia (UBC) and Simon Fraser University (SFU), which raised research grants[7] totalling $364M and $49M, respectively, in 2004/05. Vancouver's life sciences sector benefits from numerous research facilities linked to biotechnology at UBC,[8] as well as from partnerships with global pharmaceutical companies.

The IT sector also benefits from synergies that have been created among thriving digital media, film and television industries. The sector is strengthened by the presence of video game giants such as Electronics Arts Canada, AirGames Wireless, Blast Radius Inc. and Nokia Canada.

Between 2000 and 2005, Vancouver VC investments lagged other technology hubs in Canada such as Toronto, Montréal and Ottawa. On a per capita basis, however, Vancouver ranked second after Ottawa in 2006. The British Columbia Technology Industry Association (BCTIA) believes that Vancouver is poised for continued growth despite challenges facing British Columbia and Vancouver, mainly a shortage of people with extensive marketing and technical support skills, as well as a lack of VC funds to provide needed follow-on capital required to build anchor companies.

Over the years, the Government of British Columbia has established a number of tax-oriented programs and policies designed to encourage VC investment. For example, the Equity Capital Program provides a 30-percent refundable tax credit to investors who invest in eligible[9] small businesses. As described earlier, the Government of British Columbia launched the new BCRCF, which augments its other taxoriented policies. This fund should further stimulate VC investments in Vancouver with its focus on the biotechnology, IT, new media and clean technology sectors.

▲ Top

Notes

This publication is part of a series prepared by the Small Business Policy Branch. The branch analyses the financial marketplace and how trends in this market impact small businesses' access to financing. Current research is focused on high-growth firms, the aspects of both Canada's VC and general business environment that affect the success of these firms, and the key players in the risk-capital market (for example, VC firms and angels).

The Small Business Policy Branch is also responsible for the Small and Medium-Sized Enterprise Financing Data Initiative (SME FDI). The SME FDI is a comprehensive data-collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of and demand for financing by small and medium-sized businesses. Further information and statistical findings and reports are available at www.sme-fdi.gc.ca.

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Top

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[1] New media includes film and film post-production services, visual effects, digital gaming, animation and interactive media.

[2] The complete text of the Strategy can be found at www.ic.gc.ca/s&tstrategy.

[3] Institutional investors can include pension funds, insurance companies and university trust.

[4] Flow-through entities are recognized taxation vehicles whose income flows through to its members for tax-

reporting purposes.

[5] Institutional investors in the U.S. are mostly tax-sheltered entities.

[6] Shares listed on a prescribed stock exchange automatically constitute eligible investments for registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs) and deferred profit sharing plans (DPSPs). They are securities that qualify for rules pertaining to securities lending arrangements and, most importantly, are excluded from the application of withholding requirements under section 116 of the *Income Tax Act*.

[7] Vancouver Economic Development website: www.vancouvereconomic.com.

[8] These facilities are the Biomedical Research Centre, Michael Smith Biotechnology Laboratories, Bioinformatics Centre, Brain Research Centre, James Hogg iCapture Centre for Cardiovascular and Pulmonary Research, and Centre for Molecular Medicine & Therapeutics.

[9] Eligibility criteria are that the small and medium-sized enterprise (SME), with all its affiliates: 1) have no more than 100 employees, 2) pay at least 75 percent of the wages and salaries to employees who regularly report to work in British Columbia, and 3) be substantially engaged in a prescribed activity. Prescribed activities are those related to manufacturing; processing or export of value-added goods produced in British Columbia; destination tourism; research and development of proprietary technology; development of products for interactive digital new media; or community diversification outside of the Lower Mainland and the Capital Region.

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